**FEDERAL RESERVE SYSTEM**

**12 CFR Part 204**

**Regulation D; Docket No. R-1334**

# Reserve Requirements of Depository Institutions

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Interim final rule; request for public comment.

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**SUMMARY:** Under authority of section 128 of the Emergency Economic Stabilization Act of 2008, the Board is amending Regulation D, Reserve Requirements of Depository Institutions, to direct Federal Reserve Banks to pay interest on balances held at Reserve Banks to satisfy reserve requirements and on balances held in excess of required reserve balances and clearing balances. The Board is also making associated minor changes to its clearing balance policy and the method for recovering float costs.

**DATES:** Effective date: This interim final rule is effective October 9, 2008. Comments must be received on or before November 21, 2008.

**ADDRESSES:** You may submit comments, identified by Docket No. R-1334, by any of the following methods:

**Agency Web Site:** http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm. Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

**E-mail:** regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.

**Fax:** (202) 452-3819 or (202) 452-3102.

**Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

All public comments are available from the Board's web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information.

Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

**FOR FURTHER INFORMATION CONTACT:** Sophia H. Allison, Senior Counsel (202/452-3565), Legal Division, or Margaret Gillis DeBoer, Senior Financial Analyst (202/452-3139), Division of Monetary Affairs; for information with respect to the clearing balance policy and float calculations, Jonathan Mueller, Senior Financial Analyst (202-530-6291), Division of Reserve Bank Operations and Payment Systems; for users of Telecommunications Device for the Deaf (TDD) only, contact (202/263-4869); Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, DC 20551.

**SUPPLEMENTARY INFORMATION:**

## I. Background

Section 128 of the Emergency Economic Stabilization Act of 2008, enacted on October 3, 2008 (the "2008 Act"), accelerated the effective date of the authority for the Federal Reserve Banks to pay earnings on balances maintained at the Reserve Banks by or on behalf of depository institutions. The 2008 Act made this authority effective on October 1, 2008. This authority was originally enacted in Title II of the Financial Services Regulatory Relief Act of 2006 (the "2006 Act") (Pub. L. 109-351, 120 Stat. 1966 (Oct. 13, 2006), with an original effective date of October 1, 2011. The 2006 Act provides that such earnings must be paid at least once each quarter at a rate not to exceed the general level of short-term interest rates. The 2006 Act also provides that the Board may prescribe regulations concerning the payment of earnings, the distribution of earnings to the depository institutions that maintain balances or on whose behalf balances are maintained, and the responsibilities of correspondents to distribute and credit earnings on balances maintained by the respondent on a pass-through basis with the correspondent.

The Board is publishing this interim final rule amending Regulation D (Reserve Requirements of Depository Institutions) to direct the Federal Reserve Banks to pay interest on balances held at Reserve Banks to satisfy reserve requirements ("required reserve balances") and balances held in excess of required reserve balances and clearing balances ("excess balances"). Reserve Banks will not pay explicit interest on clearing balances (balances that an institution holds to satisfy a contractual clearing balance agreement). Clearing balances will, however, continue to earn earnings credits under the existing clearing balance policy, although the Board has made minor adjustments to the calculations of earnings credits and float costs to be recovered that are related to reserve requirements. In addition, the Board has eliminated transitional adjustments for reserve requirements in the event of a merger or consolidation.

In the past, the absence of interest payments on required reserve balances acted as a tax on depository institutions' issuance of deposits subject to reserve requirements. To the extent that depository institutions could not satisfy reserve requirements with vault cash, they were required to hold more balances than they otherwise would in a non-interest-bearing account at a Reserve Bank. The absence of interest on excess balances has meant that, when reserve supply significantly exceeds demand, the federal funds rate can fall to as low as zero.

The ability to pay interest on balances held at Reserve Banks should help promote efficiency and stability in the banking sector. Paying interest on excess balances will permit the Federal Reserve to expand its balance sheet as necessary to provide sufficient liquidity to support financial stability while implementing the monetary policy that is appropriate in light of the

System's macroeconomic objectives of maximum employment and price stability. Paying interest on excess balances should also help to establish a lower bound on the federal funds rate. Eligible institutions (defined below) will presumably be unwilling to lend balances in the funds market at a rate much below that paid on excess balances maintained at a Reserve Bank. In addition, paying interest on required reserve balances will eliminate much of the reserve tax and lessen the incentive for depository institutions to engage in reserve avoidance behavior, which absorbs real resources and diminishes the efficiency of the banking system.

In light of the current severe strains in financial markets, the amendments to Regulation D will be effective on Thursday, October 9, 2008. Interest will be calculated beginning with the biweekly reserve maintenance period ending October 22, 2008, and the weekly reserve maintenance period ending October 15, 2008. Interest payments will occur within the existing framework for reserve computation and maintenance, which includes reserve averaging, carryover provisions, and reserve deficiency charges. For both excess balances and required reserve balances, interest will be paid on these balances averaged over the reserve maintenance period. This approach is consistent with the current reserves framework under which compliance with reserve requirements is measured over either a seven-day or a fourteen-day reserve maintenance period, depending generally on the size of the institution. Interest will be credited to eligible institutions 15 days after the close of the maintenance period in order to apply reserve carryover provisions. Further details on the interim final rule are discussed below. Although the amendments to Regulation D are effective on October 9, the Board seeks comments on all aspects of this proposal.

## II. Discussion

### A. Eligible institutions

The Act permits Federal Reserve Banks to pay interest on balances held by or on behalf of "depository institutions." The Act's definition of "depository institution" has a broader meaning than the definition of that term in section 19(b)(1)(A) of the Federal Reserve Act and Regulation D. To avoid confusion, the Board's rule uses the term "eligible institution" to refer to those institutions included in the 2008 Act's broader definition of "depository institution." Therefore, the definition of "eligible institution" includes the depository institutions defined in section 19(b)(1)(A) of the Federal Reserve Act, including banks, savings associations, savings banks and credit unions that are federally insured or eligible to apply for federal insurance. "Eligible institution" also includes trust companies, Edge and agreement corporations, and U.S. agencies and branches of foreign banks. The definition does not include all entities for which the Reserve Banks hold accounts, such as entities for which the Reserve Banks act as fiscal agents, including Federal Home Loan Banks.

### B. Rate

Interest will be paid on average required reserve balances and average excess balances maintained over a reserve maintenance period. The Board has established the initial rate of interest for required reserve balances to be the average targeted federal funds rate over the reserve maintenance period less 10 basis points. Setting this rate below the targeted federal funds rate reflects the fact that federal funds loans are uncollateralized and carry some counterparty risk, whereas deposits at the Federal Reserve Banks are free from such risk. Therefore, establishing some spread below the funds rate reflects the risk-free nature of a deposit at the central bank. The choice of 10 basis points is approximately equal to the average spread between the overnight rate on repurchase agreements secured by general Treasury collateral and the overnight rate on federal funds in recent years but prior to the onset of the current financial turmoil.

The Board has established the rate of interest for excess balances to be the lowest targeted federal funds rate during the reserve maintenance period less 75 basis points. The Board believes the rate on excess balances should be set sufficiently low to provide an incentive for eligible institutions to trade funds in excess of required reserve balances and clearing balances in the federal funds market, but to provide a disincentive to trade funds at rates far below the targeted federal funds rate. The Board may adjust the formula for the interest rate on excess balances in light of experience and evolving market conditions. Basing the rate on excess balances on the lowest rate, rather than the average rate, for the reserve maintenance period will support the funds rate better during periods when the Federal Open Market Committee eases monetary policy. If the average targeted rate were used, then during a maintenance period in which policy was eased, the rate on excess balances might be too close—or even above—the new targeted rate.

C. Treatment of correspondent balances

Balances that earn interest. Correspondents provide various services to respondent institutions, such as check and cash services. Under the Federal Reserve Act and Regulation D, certain respondents may also elect to pass their required reserve balances through their correspondents to the Federal Reserve Banks for the purposes of satisfying reserve requirements, rather than holding balances directly with a Reserve Bank. A pass-through correspondent is responsible for holding sufficient balances in its account at the Reserve Bank to satisfy its own required reserve balance, its own clearing balance (if any), and the aggregate required reserve balances of its respondents. In addition, certain institutions may act as pass-through correspondents under the Federal Reserve Act and Regulation D even though they are not themselves "eligible institutions" under this interim final rule, such as Federal Home Loan Banks.

Under the interim final rule, the Reserve Banks will pay interest on required reserve balances maintained by or on behalf of an eligible institution, even if the pass-through correspondent for the eligible institution is itself not an eligible institution. In the case of a pass-through correspondent that is not an eligible institution, the required reserve balances held in the correspondent's account will be solely those held to meet its respondent's reserve requirements. Where the pass-through correspondent is an eligible institution, the required reserve balances in the correspondent's account may include those balances held by the correspondent to meet its own reserve requirement, if any, as well as those held to meet its respondent's reserve requirements.

The interim final rule also provides that the Reserve Banks will pay interest on excess balances held by or on behalf of eligible institutions, even if the pass-through correspondent for the eligible institution is itself not an eligible institution but has excess balances in its account.

Without imposing additional reporting or accounting requirements, Reserve Banks cannot determine whether all or part of the excess balances in a pass-through correspondent's account at a Reserve Bank are held on behalf of respondents. In light of this problem, and in order to avoid imposing additional reporting or accounting burdens, the interim final rule deems all of the excess balances held in the account of a pass-through correspondent that is not an eligible institution to be held on behalf of that correspondent's respondents. Accordingly, all interest received on excess balances by such pass-through correspondents are attributable solely to the excess balances of their respondents.[1/] This provision enables pass-through correspondents and respondents to continue to negotiate the structure of their contractual relationships with maximum flexibility, including negotiations regarding the appropriate distribution of earnings received on behalf of respondent balances.

The Board requests comment on any alternative methods of determining whether all or part of the excess balances in a pass-through correspondent's account at a Federal Reserve Bank are held on behalf of a respondent when the correspondent itself is not an eligible institution. For example, would it be feasible for a pass-through correspondent to report to the Federal Reserve the amount or proportion of its excess balances that are held on behalf of respondents? Should the Board require pass-through correspondents to certify that all or a specified portion of the excess balances in its Reserve Bank account are held on behalf of its respondents? Should the Board require all balances held by a pass-through correspondent on behalf of its respondent institutions to be held in a segregated account separate from the correspondent's other funds? Would a pass-through correspondent that was not an eligible institution be able to track respondent balances such that it could determine what proportion of its balances in its Reserve Bank account are held on behalf of its respondents? Alternately, would it be reasonable for the Board to assume that none of the pass-through correspondent's excess balances are held on behalf of a respondent?

Passing back of interest to respondents. The interim final rule provides that a pass-through correspondent may pass back to its respondent the interest paid on balances held on behalf of that respondent, but it is not required to do so. Permitting, but not requiring, the pass-back of interest earnings is consistent with the treatment of reserve deficiency charges in Regulation D. The Reserve Bank assesses a deficiency charge to the account of the pass-through correspondent for any deficiency in its account balances, even if the deficiency is attributable to a respondent. It is left to the pass-through correspondent to determine whether to assess a deficiency charge on the respondent, or whether to make any adjustments in other aspects of the correspondent-respondent relationship to deal with attribution of deficiency and other charges.

This approach also avoids interfering with existing arrangements between pass-through correspondents and respondents for services, including sweep arrangements or compensating balance requirements. Correspondent banks typically structure their respondent relationships in

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[1/] This provision is similar to others in Regulation D regarding the extent to which the Reserve Bank considers balances to belong to one institution for purposes of the account relationship, even though the funds of more than one institution may be involved. Under Regulation D, the balances in the pass-through correspondent's account are treated as being the property only of the correspondent for purposes of the relationship between the correspondent and the Reserve Bank (12 CFR § 204.3(i)(2)). This provision means that the Reserve Bank's debtor-creditor relationship is solely with the pass-through correspondent and not with any of the correspondent's respondents, even though the funds in the correspondent's account may include the passed-through required reserve balances of one or more respondents.

myriad ways, depending on a number of factors, such as services provided or balances held. Respondents may adjust the level of balances held with a correspondent in response to changes in the rates paid to them or other factors. Respondents that are not satisfied with their existing arrangements with a correspondent may take steps to renegotiate the terms of the relationship or even seek another correspondent.

The Board requests comment on whether it should require, rather than permit, pass-through correspondents to pass back to their respondents the interest payments on balances held on behalf of those respondents. Would that requirement significantly interfere with existing correspondent-respondent arrangements? Would pass-through correspondents be able to track respondent balances such that they could determine how to allocate the interest among their respondents? How would the Federal Reserve ensure that all interest belonging to a respondent had in fact been passed back?

Exemption from Regulation Q. Many eligible institutions are subject to statutory and regulatory prohibitions against payment of interest on demand deposits (see, e.g., 12 U.S.C. 461(i); Regulation Q (Prohibition Against Payment of Interest on Demand Deposits), 12 CFR Part 217)). The 2006 Act, however, expressly authorizes the Board to prescribe regulations to allow pass-through correspondents to pass interest back to respondents. Congress therefore contemplated that pass-through correspondents could pass back part or all of the interest received in a correspondent's Reserve Bank account to its respondents, even though the payment of interest on demand deposit accounts is still otherwise prohibited. The interim final rule, therefore, clarifies that when a pass-through correspondent passes back to its respondent interest paid on balances held on behalf of that respondent, such a payment is not a payment of interest on a demand deposit for purposes of Regulation Q.

## D. Transitional adjustments in mergers

The Board is eliminating the provisions in Regulation D relating to merger-related adjustments to reserve requirements.[2] These provisions, currently set forth in § 204.4 of the regulation, were originally intended to phase-in the burden associated with the higher reserve requirements that result from a merger or consolidation of depository institutions. When two or more separate institutions merge or consolidate into a single institution, the surviving institution typically has a reserve requirement that is higher than the sum of the reserve requirements of the merging institutions. The requirement is higher because the merged institution receives only one low reserve tranche and one exemption amount, while, prior to the merger, each institution had a low reserve tranche and an exemption amount.[3] Section 204.4 of Regulation D permits a phase-in of the higher reserve tax associated with a merger or consolidation over seven quarters. Interest on required reserve balances offers a much more effective method to address the reserve tax associated with mergers or consolidations because the interest earned essentially eliminates the additional tax. Moreover, the length of the adjustment period is sufficiently long that many

2 Adjustments associated with mergers completed prior to October 9, 2008, will be left in place, but no new adjustments would be issued on or after October 9, 2008.

3 The exemption amount is the amount of an institution's reservable liabilities that are subject to a zero-percent reserve requirement; currently it is set at $10.3 million. The low reserve tranche is the amount of an institution's reservable liabilities that is subject to the three-percent reserve requirement ratio; currently, it is set at 44.4 million.

institutions become part of subsequent mergers, resulting in significant complexities in required reserves calculations. The Board believes that paying interest on required reserve balances effectively negates the need for the complex adjustment provisions and therefore has deleted them in the interim final rule.

E. Clearing balance policy adjustments

Clearing balances provide a way for depository institutions to hold additional balances at the Reserve Banks to meet their clearing needs. These balances currently earn implicit interest in the form of earnings credits that can be used to cover the cost of Federal Reserve priced services. Under the current methodology for pricing Federal Reserve services, the level of clearing balances affect both costs and revenues for Federal Reserve priced services.

In light of the revisions to Regulation D, the Board has approved two related changes to the method in which earnings credits are calculated, along with a similar change to the method in which float costs to be recovered are computed. These changes discontinue practices related to reserve requirements that are no longer necessary. These adjustments previously had been made to ensure that respondents viewed balances at the Federal Reserve Banks and balances at a private-sector correspondent as equivalent.

The first earnings credit adjustment, called the “imputed reserve requirement adjustment,” imputes a marginal reserve requirement ratio of 10 percent to the Reserve Banks because a private-sector correspondent would be required to hold reserves against a respondent’s balance. If the correspondent had a marginal reserve requirement ratio of 10 percent, then it would grant credits to the respondent based on only 90 percent of the respondent’s balance because it would have to hold the remaining 10 percent in the form of non-interest-earning reserves. The Board has eliminated this adjustment because the reserves on the respondent’s balance would now earn interest at the rate on required reserve balances.

The second earnings credit adjustment, called the “marginal reserve requirement adjustment,” adjusts for the fact that the respondent could deduct the balance held at a correspondent, but not at the Reserve Bank, from its reservable liabilities. The reserve requirement reduction is equal to the respondent’s marginal reserve requirement ratio multiplied by the balance at the correspondent. This reduction has value to the respondent when it frees up balances that can be invested in interest-bearing instruments, such as a federal funds loan. The Board has eliminated this adjustment because the respondent will now be indifferent between holding balances at the Reserve Bank, and earning the rate on required reserves, or maintaining the balance at a private-sector correspondent, taking the due from deduction, and investing those funds.

The Board has also eliminated the imputed reserve requirement adjustment and adjustment for cash items in the process of collection that is applied when measuring float costs to be recovered by Federal Reserve priced services. The Reserve Banks will now have to recover 100 percent of float costs. Previously, floats costs recovered by priced services were reduced by 10 percent. The adjustment imputed a reserve requirement to the Reserve Bank, but it also allowed the Reserve Banks to adjust the imputed required reserves by the adjustment for cash items. This approach mirrored that of a private-sector correspondent. There is no longer a need to impute a reserve requirement to the Reserve Banks because the private-sector correspondent will now earn interest on its required reserve balance. As a result, the Reserve

Banks are no longer entitled to an adjustment for cash items.

**Administrative Procedure Act**

In accordance with the Administrative Procedure Act (“APA”) section 553(b) (5 U.S.C. § 553(b)), the Board finds, for good cause, that providing notice and an opportunity for public comment before the effective date of this rule would be contrary to the public interest. In addition, pursuant to APA section 553(d) (5 U.S.C. § 553(d)), the Board finds good cause for making this amendment effective without 30 days advance publication. The Board has adopted this rule in light of, and to help address, the continuing unusual and exigent circumstances in the financial markets. This rule provides tools for carrying out monetary policy more effectively. Thus, the Board believes that any delay in implementing the rule would prove contrary to the public interest and would be contrary to Congress’s intent in accelerating the Board’s authority to use these new tools to help address current market conditions. The Board is requesting comment on all aspects of the rule and will make any changes that it considers appropriate or necessary after review of any comments received.

**Regulatory Flexibility Act**

The Regulatory Flexibility Act requires an agency that is issuing a final rule to prepare and make available a regulatory flexibility analysis that describes the impact of the final rule on small entities. 5 U.S.C. § 603(a). The Regulatory Flexibility Act provides that an agency is not required to prepare and publish a regulatory flexibility analysis if the agency certifies that the final rule will not have a significant economic impact on a substantial number of small entities. 5 U.S.C. § 605(b).

Pursuant to section 605(b), the Board certifies that this interim final rule will not have a significant economic impact on a substantial number of small entities. The rule implements a program for paying interest on certain balances held by eligible institutions at the Federal Reserve Banks and will benefit small institutions that receive such interest. There are no new reporting, record-keeping, or other compliance requirements associated with this rule.

**Paperwork Reduction Act**

In accordance with the Paperwork Reduction Act (44 U.S.C. § 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed the interim final rule under authority delegated to the Board by the Office of Management and Budget. The rule contains no collections of information pursuant to the Paperwork Reduction Act.

**Plain Language**

Section 772 of the Gramm-Leach-Bliley Act requires the Board to use “plain language” in all proposed and final rules. In light of this requirement, the Board has sought to present the interim final rule in a simple and straightforward manner. The Board invites comment on whether the Board could take additional steps to make the rule easier to understand.

**List of Subjects in 12 CFR Part 204**

Banks, banking, Reporting and recordkeeping requirements

**Authority and Issuance**

For the reasons set forth in the preamble, the Board is amending 12 CFR part 204 as follows:

**PART 204 -- RESERVE REQUIREMENTS OF DEPOSITORY INSTITUTIONS**

**(REGULATION D)**

1. The authority citation for part 204 continues to read as follows:
Authority: 12 U.S.C. 248(a), 248(c), 371a, 461, 601, 611, and 3105.
2. Section 204.4 is removed and reserved.

**§ 204.4 [Reserved]**

3. Section 204.10 is added to read as follows:

**§ 204.10 Payment of interest on balances.**

(a) Payment of interest. The Federal Reserve Banks shall pay interest on balances maintained at Federal Reserve Banks by or on behalf of an eligible institution as provided in this section and under such other terms and conditions as the Board may prescribe.

(b) Rate. Except as provided in paragraph (c) of this section, Federal Reserve Banks shall pay interest at the following rates—

(i) For required reserve balances, at the average targeted federal funds rate over the reserve maintenance period less 10 basis points; and

(ii) For excess balances, at the lowest targeted federal funds rate during the reserve maintenance period less 75 basis points.

(c) Pass-through balances. Any excess balance held by a pass-through correspondent that is not an eligible institution is deemed to be held on behalf of the pass-through correspondent's respondents. A pass-through correspondent may pass back to its respondent interest paid on balances held on behalf of that respondent. Such a payment is not a payment of interest on a demand deposit for purposes of Part 217 of this chapter (Regulation Q).

(d) Definitions. For purposes of this section—

(1) Clearing balance means the amount that an eligible institution holds to satisfy a contractual clearing balance agreement with a Federal Reserve Bank, in addition to any required reserve balance.

(2) Eligible institution means—

(A) Any depository institution as described in § 204.1(c);

(B) Any trust company;

(C) Any corporation organized under section 25A of the Federal Reserve Act (12 U.S.C. 611 et seq.) or having an agreement with the Board under section 25 of the Federal Reserve Act (12 U.S.C. 601 et seq.); and

(D) Any branch or agency of a foreign bank (as defined in section 1(b) of the International Banking Act of 1978, 12 U.S.C. 3101(b)).

(3) Excess balance means the average balance held in an account at a Federal Reserve Bank by or on behalf of an eligible institution over a reserve maintenance period that exceeds the sum of the required reserve balance and any clearing balance.

(3) Required reserve balance means the average balance held in an account at a Federal Reserve Bank by or on behalf of an eligible institution over a reserve maintenance period to satisfy the reserve requirements of this part.

(4) Targeted federal funds rate means the federal funds rate established from time to time by the Federal Open Market Committee.

By order of the Board of Governors of the Federal Reserve System, October 6, 2008.

Jennifer J. Johnson (signed)

Jennifer J. Johnson,
Secretary of the Board.